# INITIAL STATEMENT OF REASONS

## Adoption of Section 590 – Investment Policy and Asset Allocation Strategy for the Terminated Public Agencies

### Description of Public Problem, Administrative Requirement, or Other Condition or Circumstance that the Regulation is Intended to Address:

Due to the current economic environment and budget issues public agencies are facing, there is increasing pressure on public agencies to amend or terminate their pension plan contracts. As a result, there is a need to examine the current Terminated Agency Pool (Pool) assets and liabilities, and analyze the potential risks that exist in the event there is an increase in the number of public agencies opting to terminate their pension plan contracts.

Under the current funding methodology there is a risk that the California Public Employees Retirement System (CalPERS) will not be able to meet its obligation to its members at some point in the future if some of the actuarial assumptions were not realized. Although currently the Pool is overfunded, the termination of one employer (or a number of smaller employers) with liabilities in excess of $500 million could significantly dilute the funded status of the Pool and substantially increase this risk.

### Specific Purpose:

- The proposed regulations are intended to provide CalPERS the ability to credit the Pool with income and interest earned on those Pool assets in accordance with any strategic investment policy and/or asset allocation strategy determined by the CalPERS Board for the Pool. This change will enable CalPERS to limit the risk of not meeting its obligation to its members. CalPERS has adopted changes in concept in August 2011. By changing the investment policy and asset allocation strategy, existing assets in the Pool will closely reflect and match the characteristics of future expected benefit payments of the Pool.

### Necessity:

Under the current termination process, the termination of a large employer will cause the Pool funding status to be significantly diluted because CalPERS only requires the employer to contribute an amount that is equal to one hundred and seven percent of the employer's liability at termination.

For example, if a public agency with $500 million in liabilities terminates and becomes part of the Pool, the funded status of the current Pool would decrease from 240 percent to 121 percent. Should an agency with $1 billion in liabilities terminate, the funded status would be diluted to 115 percent.

Should assets be insufficient to cover benefit obligations, CalPERS recourse against terminated agencies may be inadequate as CalPERS assumes responsibility for the member obligations at the time of an agency's termination. The PERL provides that benefits may be reduced, in the case that an employer fails to pay its required contributions; however, it is possible that retirees and beneficiaries may have a claim against the California Public Employees' Retirement Fund and/or CalPERS. This is particularly true if the underfunded status of the Pool is not attributable to an agency's failure to make required contributions. Given that CalPERS charges a terminating agency only a seven percent margin, it is possible that the Pool could be underfunded even when the agency paid the amount required by CalPERS at the time of termination.

If the Pool should ever fall below 100 percent on a market value basis the Pool would need an investment return above the assumed rate of return to remain solvent or experience another type of actuarial gain such as members dying or refunding faster than expected. This is because CalPERS would no longer receive contributions from retirees or employers on their behalf

Changing the investment policy and asset allocation strategy in the Pool to reflect and match the characteristics of future expected benefit payments is the only alternative that adequately addresses the obligation risk for the Pool. This strategy is a technique that coordinates the movement in values of both assets and liabilities when interest rates change. It does so by tying asset allocation decisions into the plan's liability structure.

The two main methods are exact cash flow matching and duration matching. For exact cash flow matching, liabilities are examined and cash flows are predicted, then bonds are selected to match those cash flows with the bond's coupons and maturity payoffs. Duration matching matches the change in liabilities to the change in the bond portfolio as interest rates change. If interest rates change one percent and the liabilities change 15 percent, then the value of the bond portfolio would be in the same direction and percentage.

At its August 2011 meeting the CalPERS Board adopted in concept changes to the investment policy and asset allocation strategy for the existing assets in the Pool to reflect and match the characteristics of future expected benefit payments of the Pool.

Over the next few months, the CalPERS Board will be adopting a specific investment policy to achieve this goal.  The proposed regulation changes are required in order to ensure that CalPERS has the ability to credit the Pool with income and interest earned on those assets in accordance with any strategic investment policy and/or asset allocation strategy determined by the CalPERS Board for the Pool.

The assets of the Pool are currently invested with all the assets of employers participating in the Public Employee's Retirement Fund (PERF) and are all subject to the same investment policy. Once the assets of the Pool are invested differently from the rest of the PERF, there is a necessity to credit income and interest to the Pool and to the other employers of the PERF differently. Without these regulations, the Pool would be credited with income and interest earned by all assets of the PERF and would not reflect the way the assets of the Pool are invested. Similarly, without the proposed regulation the assets of other employers in the PERF would also be credited with income and interest that would not reflect the way their assets are invested.

## Technical, Theoretical and/or Empirical Studies, Reports or Documents:

Not applicable.

## Alternatives to the Regulatory Action and Reasons CalPERS Should Reject Those Alternatives:

The CalPERS has already adopted in concept that in order to mitigate the risk associated with the current pool it will change the way the assets of the Pool are invested. Without this regulation that would allow CalPERS to allocate the income in accordance with the way the assets are invested, three other options exist to mitigate the risk associated with the current Pool. They are are described below:

1. Increase Mortality Margin – Replace the seven percent mortality margin at entry with a 20 percent margin – At present, the termination of an employer with $1 billion in liabilities using a 20 percent margin would lower the Pool's funded status to 127 percent.

2. Make no changes to contribution amounts or investments and, in the event of underfunding, use the reserve for contingencies to cover loses.[1]

3. Post-Termination Valuations and Billing – Allow plan terminations but do valuations every three years and send obligation payments if funded status drops below a pre-determined level.

While increasing the mortality margin and drawing funds from the reserve could prove beneficial in the short-term, these proposals do not provide significant protection from future market loses. On the other hand, requiring employers to make subsequent contributions, based on regular valuations, could protect the Pool from substantial funding loss in the event of market losses. However, this protection is effective only to the extent the terminated agencies actually make

[1] This may require legislation.

the additional contributions. Should an agency cease to exist, CalPERS would be unable to collect additional contributions. Both Contra Costa County Employees' Retirement Association (CCCERA) and the Municipal Employees' Retirement System (MERS) of Michigan use regular valuations and seek obligation payments following contract termination. MERS also charges terminating employers a 20 percent mortality margin, but will refund payments should their terminated agency pool funding rise above 130 percent.

None of these alternatives adequately addresses the obligation risk for the Pool. Investing the assets of the Pool to reflect and match the characteristics of future expected benefit payments of the Pool is the best approach to mitigate this obligation risk borne by CalPERS and this regulation is needed to adequately allocate income and interest to the Pool.

## Alternatives to the Regulatory Action that Would Lessen any Adverse Impact on Small Businesses:

The proposed action has no cost impact on small businesses because it applies only to public agency employee retirement benefits.